JerusalemPapersinRegulation&Governance

Working Paper No.3
April 2010

Beyond the Logic of the Market:

Toward an Institutional Analysis of Regulatory Reforms

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Jerusalem Forum
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Marc Allen Eisner

ABSTRACT: This paper examines deregulation from an institutional perspective. Although deregulation is commonly framed as the diminution of state control and a return to "the market," the paper argues that this portrayal fails to acknowledge both the complexities of governance and the role of the state in shaping decisions about governance. It is argued that the category of "the market" subsumes a variety of governance mechanisms that economic actors use to coordinate their behavior. Moreover, the market-state dichotomy within which discussions of deregulation are commonly framed ignores the central role of the state in shaping decisions regarding governance. Following deregulation, industry actors commonly employ various governance mechanisms (e.g., long-term contracting, obligational networks) that have little in common with classical markets. Moreover, the evolution of governance regimes is not simply driven by efficiency concerns but is shaped by public policies and institutions. Thus, even under deregulation, the role of law and institutions is foundational. The paper illustrates these points through three cases of deregulation in the United States: commercial aviation, railroads, and finance.

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Beyond the Logic of the Market: Toward an Institutional Analysis of Regulatory Reforms

After a nearly a century of regulatory expansion, the United States entered a period of regulatory reform in the mid-1970s. During the previous decade, the case for government regulation came under prolonged scrutiny. Activists consumer movement and identified serious cases of regulatory failure and compiled case studies that reinforced earlier scholarly works on regulatory capture and life cycles (see Herring 1938, Huntington 1952, Bernstein 1955, Kolko 1963). The critique of regulation was not the sole property of the left. Chicago school economists were developing the economic theory of regulation, modeling regulation as a series of mutually-beneficialexchanges between profit-maximizing firms and vote-maximizing legislators (see Stigler 1971). Despite the obvious ideological differences, there was a broad consensus that many regulations protected the regulated interests, foisting the costs on to the public. As the arguments against regulation mounted, stagflation created a window of opportunity for policy change. Excessive regulation was linked—albeit, often only rhetorically—to rising inflation, stagnant growth, and flailing competitiveness. Policymakers concluded that the costs of economic regulations often exceeded whatever benefits might be claimed. Deregulatory initiatives were successfully introduced in commercial banking, communications, and air and surface transportation. In some cases, these initiatives mandated the wholesale elimination of well-established regulatory agencies. When combined with the rejection of Keynesian demand management, the promotion of greater trade liberalization, and welfare reform, deregulation became one of the pillars of neoliberalism. If earlier policy regimes had vested authority in state institutions in the hope of forcing higher levels of corporate accountability and compensating for market failure, these grants had been revoked in the name of efficiency.

Deregulation was only one part of the reform agenda. Beginning in the early 1970s, presidents established ever more demanding systems of regulatory review. Although the Ford and Carter administrations imposed relatively unobtrusive analytical requirements such that agencies could often compose cost-benefit analyses *ex post facto*, the Reagan presidency marked a sea change. In 1981, Reagan's

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executive order 12291 required agencies to submit regulatory impact analyses grounded in cost-benefit analysis to the Office of Management and Budget's Office of Information and Regulatory Affairs (OMB OIRA). If agencies failed to make the affirmative case that new regulations generated net benefits, OMB OIRA was authorized to prohibit them from publishing notice of rulemaking in the *Federal Register,* thereby stopping the regulatory process (McGarity 1991). Even if the new social regulatory agencies like the Environmental Protection Agency (EPA) and the Occupational Safety and Health Administration (OSHA) survived the deregulatory fervor of the era, they were deeply impacted by the new review requirements. The timing of costs and benefits intrinsic to many social regulatory policies—they imposed large initial compliance costs and generated a flow of benefits that accrue in the distant future—were particularly difficult to justify when discounted to present value. Moreover, the costs of completing the regulatory impact analyses stressed the resources of agencies already working under significant budgetary constraints.

There is much to suggest that the introduction of regulatory review processes had less to do with the promotion of market values than with inter-branch conflicts (see Percival 1991, 2001). In the 1970s, Congress passed the costliest regulatory statutes in US history. Responding to the above-mentioned critiques of regulatory capture and anxious to assert control over new agencies, legislators wrote exhaustively detailed regulatory statutes that limited the discretionary authority of regulators and, by implication, the capacity of the President to manage the regulatory state. By vesting authority in the OMB within the Executive Office of the President, regulatory review partially redressed the perceived imbalance of power. Although it was convenient in the 1980s to attribute these changes to the Reagan administration's anti-regulatory ethos, these processes were retained, albeit with modifications, by subsequent presidents, regardless of party affiliation and agenda. One can surmise that they were embraced, in part, to mange the balance of power between the President and Congress.

This essay focuses on deregulation and the role of the market. Advocates of deregulation claimed that the market could produce results superior to the state. And yet, as will be argued below, if we replace the broad and imprecise category of "the market" with a more institutionally-rich understanding of economic governance, we

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discover that deregulation produced results that often bore little resemblance to classical markets. Rather, what emerged were complex governance structures that, in some ways, served coordinative functions comparable to what had existed under regulation. Moreover, these governance decisions were not simply the product of chance or the search for efficiencies. They were shaped by public policy and investment decisions. The following examination proceeds in three stages. First, it explores the limitations of the market-state dichotomy. Second, it turns to consider regulation and deregulation through the lens of governance, with a brief survey of three cases of deregulation: airlines, surface transportation, and finance. Finally, the discussion concludes with a consideration of the merits of adopting an institutional perspective when considering the dynamics of deregulation.

Public Authority and the Market

Much of our thinking about public policy is shaped by the market-state dichotomy. The market is portrayed as a pre-political world populated by self-interested rational actors executing mutually beneficial voluntary transactions. In sharp contrast, the state is portrayed a world of coercion in which large bureaucratic organizations impose sanctions to force individuals to do things that they might otherwise choose not to do in hopes of achieving some larger, overarching social goals. The positive theory of market failure offers some technical guidance as to when the state can "intervene" in the market system (See Weimer and Vining 1999, pp. 74-116). That is, interventions are justified if they address various forms of market failure. Of course, even if such justifications exist, critics caution, the costs of government failure may nonetheless surpass the benefits of intervention. As Charles Wolf, Jr. (1990, p. 6) observed: "The choice in actuality is among imperfect markets, imperfect governments, and various combinations of the two. The cardinal economic choice concerns the degree to which markets or governments—each with their respective flaws—should determine the allocation, use, and distribution of resources in the economy."

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As powerful as the market-state dichotomy has been in structuring our thinking and public discourse about the political economy (Lindblom 1982), the conceptual bifurcation veils the variety of institutions subsumed by "the market" and the role that the state plays in creating the institutional foundations for the economy. Markets are institutions that facilitate the exchange of property. For property rights to be effective, they must be definable, defensible, and divestible or transferable (Yandle 1999). In each of these dimensions, the state plays a foundational role (e.g., by awarding titles, providing laws that govern transactions, and maintaining institutions for the adjudication of property disputes). Thus, rather than existing as a self-constituting and self-regulating sphere of human action, markets are constituted by public policies and institutions.

We can gain some additional insights into the state-market nexus by exploring the legal foundations of economic activity. The key actors in the economy—corporations, trade associations, labor unions, banks—are legally constituted entities (See Edelman and Suchman 1997). Consider the corporation. One can model the corporation as a production function, but the corporate charter is a legal document that conveys a particular combination of legal rights and privileges (e.g., limited liability) to organizations that meet particular requirements with respect to organization, governance, and reporting. Banks as deposit-taking and loan-making institutions can operate if and only if they are chartered, and this requires meeting legal requirements regarding capitalization, reserves, and governance. Workers may choose to organize, but the process of unionization is heavily regulated in the US by the National Labor Relations Act and the policies of the National Labor Relations Board. In addition to constituting the key organizational actors in the economy, the law delimits the forms of activity and organization that economic actors may employ in their interactions with other actors

In addition to obfuscating the varied ways in which the state shapes economic behavior, the dichotomous variables of market and state conceal the variety of governance arrangements that are subsumed by "the market." In the past several decades, economic sociologists and political economists have devoted much attention to exploring the different ways in which economic organizations coordinate their behavior and the ways in which law has shaped the evolution of economic governance

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in different industries and cross-nationally (See Campbell, Hollingsworth, and Lindberg 1991, Hollingsworth and Boyer 1997, Fligstein 2001). In this research, social scientists present a "market" not as a synonym for the economy, but as one of an array of governance mechanisms that economic actors can use to coordinate their behavior. In its purest form, a market is a decentralized system of exchange linking formally autonomous actors engaged in a self-liquidating transaction. Although it provides an appropriate means of coordinating behavior when transactions involve standardized goods or commodities, a market does not support the long-term coordination of specific parties nor can it support transactions that involve higher levels of complexity or asset specificity, both of which, under conditions of bounded rationality and informational asymmetry, increase uncertainty and the vulnerability to miscommunication, shirking, and opportunism. Under these conditions, alternative governance mechanisms (e.g., long-term contracting, joint ventures, or, at the extreme, integration) are common. Governance extends to multilateral settings as well. Corporations may seek to coordinate their actions through membership in trade associations or through compliance with the codes issued by standard-setting organizations. They may move toward a weak form of integration through interlocking directorates, research and development alliances, or obligational networks (See Williamson 1985; See Alexander 1995).

The evolution of governance regimes—the combination of governance mechanisms in a given industry—cannot be understood without recognizing the role of the state. As noted above, law plays a central role in constituting the economy and facilitating various forms of action. In so doing, it creates an institutional structure within which governance regimes evolve (Campbell and Lindberg 1990). Antitrust laws determine the extent to which firms can coordinate their behavior through associational activities. There is much to suggest that the great merger wave at the turn of the twentieth century was a response to antitrust prohibitions on conspiracies in restraint of trade that effectively foreclosed associational coordination (Bittlingmayer 1996).In contrast, other regulatory policies have explicitly promoted the use of associations to coordinate activities within a given industry (e.g., agricultural marketing associations, labor unions, over-the-counter brokerages). In addition to creating the institutional context within which governance regimes evolve,

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the state may be an actor, setting rates, assigning markets, and/or controlling conditions of entry and exit. This brings us necessarily to a discussion of regulation.

Regulation, Deregulation, and Governance

Although much of the work on governance has focused exclusively on the private sector, if we understand governance as the coordination of economic organizations, then we must recognize the important role played historically by regulatory policies. As with private governance mechanisms, regulatory agencies coordinate the behavior of economic organizations, thereby bringing greater stability to the industries in question. This was particularly the case with the economic regulations that were the targets of deregulation in the 1970s and 1980s. The Civil Aeronautics Board determined the terms of competition by controlling entry, assigning route authority, and regulating fares. Carriers did not have to develop their own mechanisms for coordination because regulators executed these functions. A comparable story could be told with respect to the regulation of surface transportation by the Interstate Commerce Commission. In finance, regulations literally created separate sub-industries and through interest rate regulations eliminated price competition.

The examples of regulation as governance can be extended into social regulation. In the 1990s, the Clinton administration's "reinvention of government" initiatives involved the creation of myriad public-private partnerships. For example, Partners for the Environment, a collection of reinvention projects, involved collaboration between the EPA and some 11,000 organizations, including corporations, trade and professional associations, state and local regulators, advocacy groups, and research institutions. Many of these partnerships were designed explicitly to create a means of coordinating corporate efforts and disseminating best practices. A new regulatory green track, the National Environmental Performance Track (or NEPT) was created in 2000 to give greater flexibility in compliance to organizations with a high quality environmental management system and an exhibited capacity for exceeding regulatory goals. The EPA's Performance Track Participants' Association sponsored annual conferences as vehicles for members to share information and

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coordinate their practices. While NEPT and the other EPA partnerships did not engage the classical issues addressed by economic regulation, they nonetheless constituted governance mechanisms for firms seeking to coordinate their behavior and manage an uncertain regulatory environment.

Regulations can constitute important governance mechanisms, at the extreme literally dictating the terms of competition and the structure of an industry. Deregulation, in turn, is not fruitfully understood as a return to "the market." Rather, one must explore the way in which changes in policy have stimulated the search for new governance mechanisms and the way this search has been shaped by existing policies and institutions. In some cases, formerly regulated firms may adopt markets as a means of coordinating their behavior. In other cases, they may develop more complex governance structures that may, in important respects, serve functions comparable to those served by previous regulations. The impact of deregulation on the organization of industry is an empirical question that is best understood through the analysis of changes in industry practices and organization. Let us consider, in brief, three cases of deregulation.

Deregulation and commercial aviation

Beginning in 1940, the Civil Aeronautics Board (CAB) regulated US commercial aviation. It controlled entry into the industry, assigned route authority, and regulated fares. During the 1970s, concerns over CAB performance and the inflationary impacts of economic regulation led to the passage of the Airline Deregulation Act of 1978, which phased out CAB and its regulations (the Federal Aviation Administration retained responsibilities for safety regulation). Advocates of deregulation predicted that deregulation would stimulate new entry, place downward pressure on fares via heightened price competition, and provide an expansion of air travel more generally. These predictions were more than borne out in subsequent decades. Between 1978 and 2005, total passenger miles more than tripled from 188 billion to 584 billion. Deregulation, moreover, had the predicted impact on fares: between 1980 and 2005, inflation-adjusted fares fell by almost 40 percent (US Government Accountability Office 2006, p. 11).

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The governance structures that evolved within a deregulated environment bore little resemblance to what one might characterize as classical markets. Under deregulation, major carriers moved from point-to-point routes to hub-and-spoke systems that offered a number of cost-based benefits. Smaller planes filled to capacity could transport travelers to hubs, reserving larger planes for travel between hubs. Maintenance and services could be consolidated at hubs. Although hub-and-spoke system allowed for clear efficiencies, there were also strategic concerns at work. Hub airports were usually dominated by one or two airlines that could effectively control travel between locations. The allocation of hubs among legacy carriers was the inheritance of route assignments under regulation. Under the earlier regime, legacy carriers secured exclusive-use gate leases and voice in the approval of subsequent expansions in return for their financing of airport revenue bonds (Morrison and Winston 2000, pp. 4, 22). With deregulation, control over gates became a barrier to entry with significant implications for the survival of new entrants. Although fifty-eight carriers started operation between 1978 and 1990, by 2000, only American West was still in operation, and it merged with US Airways in 2005. Legacy carriers absorbed many of these new carriers, particularly during the 1980s merger wave. As a result of this consolidation and control of hub gates, by the late-1990s, a dominant carrier controlled between 70 and 91 percent of the market share at fifteen major airports, and between 50 and 70 percent at another six airports (Cooper 2001, p. 3, appendix 1).

Industry consolidation has been combined with the formation of domestic and international code sharing alliances. Under these alliances, carriers permit each other to market and sell seats on some of their flights by sharing their unique two-letter identification codes. Alliances can provide some clear efficiencies and allow for relatively seamless transportation. But they also support coordination within the industry. When they links commuter airlines to major carriers, they facilitate a loose form of vertical integration without formal consolidation. When they are employed by major airlines (e.g., US Airways and United Airlines), they may allow carriers to collectively capture a larger share of the traffic to a given destination. There are ongoing concerns that commuter lines and some non-legacy entrants may be at a competitive disadvantage if they are not integrated into an alliance (Ito and Lee 2007).

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The continued dominance of legacy airlines in a deregulatory environment has been a product of governance decisions. But these decisions have been shaped by public policy in three ways. First, the government is partially responsible for investment in airport expansion and the operation of the air traffic control system. Additional public financing of airport and gate expansion could facilitate entry. However, the inadequacy of funding from the Airport and Airways Trust Fund—diverted to cover regulatory budgets—has rendered airport authorities dependent on major carriers for financing, thereby extending earlier patterns of control. As Elizabeth Bailey (2002, p. 17) observes: "instead of using regulation to open competition, airport policy has locked in monopoly elements." Second, the consolidation process described above was facilitated by decisions about antitrust enforcement, which lagged in the 1980s. Third, the federal government, through the policies of the Pension Benefit Guarantee Corporation (PBGC), has underwritten the profitability of the legacy carriers. As several large carriers used bankruptcy protection to restructure their debt in the wake of the terrorist attacks of September 11, 2001, the PBGC assumed a significant portion of their defined-benefit pension liabilities (some $8.9 billion). These financial rescues carried a significant *quid pro quo*. As the PBGC provided a subsidy worth billions of dollars, it acquired a major equity stake in the airline industry. As a result of bankruptcy proceedings, the PBGC was awarded a 7 percent stake in US Airway and, more strikingly, a 23.4 percent stake in United Airlines, making it the single largest investor in the airline (US Government Accountability Office 2006, p. 4). Ironically, under deregulation the state assumed an ownership stake that few would have imagined to be one of the consequences of market-based reforms.

Deregulation and the railroads

The Interstate Commerce Act of 1888 created the Interstate Commerce Commission (ICC) to regulate the railroads. After the passage of the Hepburn Act of 1906, the ICC was granted rate-making powers and assumed the role of a classical economic regulator (i.e., controlling entry, exit, the terms of competition, and pricing). With the passage of the Motor Carriers Act of 1935, the ICC's jurisdiction was extended to

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interstate trucking and thus, its decisions would have an important impact on shaping the relative fortunes of these two modes of surface transportation. During the post-World War II era, ICC regulation had dire consequences for the performance of the railroads. The ICC set the fares for manufacturing goods high relative to other commodities, thereby allowing trucking to capture a growing share of this lucrative market and leaving the railroads with the low profit margin traffic. The railroads' share of surface rate market (as measured in ton-miles) fell from 65 percent in the immediate postwar period to 35 percent by the 1970s. Rates of return on investments averaged 2 percent during the 1970s, and a wave of bankruptcies (including the Penn Central bankruptcy of 1970—the largest, thus far, in US history) created great pressure for deregulation (Bailey 1986, pp. 1211-1212; Grimm and Winston 2004, p. 41).

The Railroad Revitalization and Reform Act of 1976 provided some financial assistance for the railroads and, more importantly, made it more difficult to challenge rates set for servicing markets where the railroads did not have market dominance. It also provided the ICC with the discretionary authority to make a finding that regulation was unnecessary for entire categories of traffic, thus creating opportunities for ICC administrators to promote a deregulatory agenda. Four years later, Congress passed the Staggers Rail Act of 1980 permitting railroads to negotiate confidential contract rates with shippers and thus the flexibility to adjust rates to engage in price competition. Maximum rate guidelines were maintained only for shipments that were "captive" to rails (i.e., when there were no other effective means of transporting goods). Ultimately, with the passage of the Interstate Commerce Commission Termination Act of 1995, the ICC was eliminated and its remaining duties were transferred to the newly created Surface Transportation Board.

Advocates of deregulation correctly predicted that market competition would help revitalize the industry while providing reduced rates. Consider the changes during the period 1981 to 2007. Railroads realized productivity gains of 164 percent. In part, this reflected a dramatic reduction in the employed workforce—from 416,251 in 1981 to 186, 812 in 2007—although it was also a product of significant changes in the organization of the industry, a point to be developed below. Inflation adjusted rail rates fell by 54 percent and by the end of the period railroads claimed some 41 percent

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of the surface market, thus reversing a long-term decline. An industry that was mired in bankruptcy in the 1970s realized a 7.4 percent rate of return on investment in the period 2000-2006 (Association of American Railroads 2008b; Davis and Wilson 2003). As in the case of airlines, advocates of deregulation would attribute these results to the marvels of the market. Yet, as with the airlines, it is clear that the railroads underwent a transformation in governance that placed minimal reliance on markets *qua* governance mechanisms.

In a deregulatory environment, the railroad industry experienced three important changes. First, the industry underwent waves of consolidation in the early 1980s and again in the mid-1990s. The twenty-two class I railroads (a category that includes the largest railroads) were reduced to seven, the largest being the BNSF Railway (formerly the Burlington Northern and Santa Fe Railway), CSX Transportation (a merger of the Seaboard System Railroad and the Chessie System), and the Union Pacific. The Surface Transportation Board, which has the responsibility of reviewing proposed railroad mergers, rarely raised concerns about consolidation until 2000, when it issued a 15 month moratorium on rail mergers in response to a proposed merger of BNSF and the Canadian National Railway (Mader 2002).

Second, with the elimination of regulatory rate setting, the railroads began to negotiate long-term bilateral contracts with shippers as a means of preventing over-capacity and better aligning physical resources and shipper demands. According to one analysis (Grimm and Winston 2004, p. 56), 84 percent of the traffic is shipped under contracts with an average duration of 2.4 years, although some contracts are as long as ten years. Within captive markets, 94 percent of shipments occur under long-term contracts. Given the prevalence of long-term contracts, there is little evidence that classical markets are a governance mechanism of choice in the rail industry.

Third, railroads embraced intermodal transportation. That is, containers could be loaded from ships or trucks and transported by flatcar only to be unloaded on to ships or trucks. Railroad participation in intermodal transportation increased dramatically under deregulation, from 3 million trailers and containers in 1980 to in excess of 12 million by 2006 (Association of American Railroads 2008c). Intermodal transportation required heavy railroad investments in "double stack" cars and

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intermodal terminals, the latter of which was facilitated, albeit only marginally, by the Intermodal Surface Transportation Efficiency Act of 1991 which allowed greater flexibility in the use of federal transportation funds (See US Government Accountability Office 2007b). Additionally, the movement toward intermodal transportation required the development of a network of partnerships with shipping and trucking companies and ports (Stagl 2002), which suggest that a loose form of integration is evolving across modes of transportation comparable to what has been exhibited in the airlines.

Although these two cases of deregulation involved very different technologies, there are some clear commonalities. As in the case of airline deregulation, the case for deregulating the railroads was premised on a belief in the efficacy of markets relative to state control and yet, the combination of governance mechanisms have little resemblance to classical markets. As in the case of airlines, the industry underwent consolidation that was facilitated by a permissive regulatory environment. Captive shippers raised concerned about the growing consolidation of the rails and there is clear evidence that they pay a premium relative to shippers who have competitive options. Although captive shippers have the right to appeal rates to the Board, the process is sufficiently costly (some $3 million per litigant) that appeals have been infrequent (US Government Accountability Office 2007a, p. 41). As in the case of airlines, railroads have adopted non-market governance mechanisms (in this case, long-term bilateral contracting) to stabilize their environments. Through intermodalism, they have increasingly moved toward integrated transportation networks.

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Deregulation and finance

The regulatory system for finance that emerged in the early decades of the twentieth century was highly complex, initially consisting of the Treasury Department's Comptroller of the Currency and, after 1913, the Federal Reserve. The Great Depression marked a watershed in financial regulation. Most importantly, the Glass Steagall Act (1933) separated commercial and investment banking. It prohibited interest on demand deposits (i.e., checking) and empowered the Fed to regulated interest rates. A newly created Federal Deposit Insurance Corporation insured deposits to prevent bank runs. Parallel institutions were created for credit unions and savings and loans. By the end of the 1930s, regulations had created distinct financial sub-industries, each defined by the products and services it offered, each with its own set of regulators. Interest rate regulations eliminated price competition and deposit insurance prevented bankruptcies, allowing for remarkable stability in finance (Hammond and Knott 1988). In investment banking, the Securities and Exchange Commission regulated the industry through information disclosure and oversight of exchanges, securities dealers, and self-regulating organizations that functioned as surrogate regulators (see McCraw 1982).

During the 1970s, the financial industry came under increasing stress. Under conditions of high inflation, interest rate regulations made it difficult to attract deposits and the very regulations that delineated the sub-industries limited the capacity of financial institutions to diversify and pursue new sources of profit. So-called "non-bank banks" (e.g., money market funds) began to offer higher rates of return. The resulting disintermediation (i.e., the flow of funds outside of regulated financial intermediaries) forced policy changes designed to accommodate market innovations. Although deregulation began incrementally, in the 1980s Congress passed major deregulatory statutes that removed many of the policies and institutions that had promoted financial stability since the New Deal. Although a detailed discussion of these laws is beyond the scope of this paper (see Worsham 1997), the key statutes deregulated interest rates and provided institutions with far greater latitude in the investments they could make. Ironically, as institutions were assuming greater risks, the laws simultaneously increased the coverage of deposit insurance.

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At first glance, one would expect these changes to be particularly beneficial for Savings and Loans (S&Ls), chartered to provide liquidity for housing markets. Inflation had driven the interest rates they had to pay to attract funds well above what could be supported by portfolios of long-term, fixed-rate mortgages. In a deregulated environment, many S&Ls made investments in commercial real estate. But when the Tax Reform Act of 1986 reduced the tax advantages of these investments, a speculative real estate bubble popped. In the end, some 525 insured S&Ls failed, more than five times the total number since the end of World War II. The Federal Savings and Loan Insurance Corporation (the entity created to insure S&L deposits) fell into bankruptcy, reporting the largest losses ever incurred by a public or private corporation. Ultimately, the costs would exceed $160 billion (see Rom 1996).

Deregulation continued despite the S&L debacle and the regulatory firewalls established by the New Deal regulations became increasingly porous. Ultimately, Congress passed the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLBA),permitting the consolidation of commercial banks, investment banks, securities firms and insurance companies in financial holding companies. While GLBA essentially revoked Glass-Steagall, many of the changes had already occurred incrementally. Through mergers and acquisitions, commercial banks had already made forays into investment banking and brokerage activities, creating more diversified financial service companies (See Barth, Brumbaugh, and Wilcox 2000). Formally separate institutions were now either consolidated or linked through a dense network of commercial relations, many of which fell outside of regulatory oversight.

While the deregulation of air and surface transportation had results that were, on balance, positive, financial deregulation and the changes in the organization of financial markets had tragic consequences. During the 1990s and 2000s, a set of policy decisions created the foundations for a speculative bubble in residential real estate. Changes in the taxation of capital gains, the Federal Reserve's promotion of historically low interest rates, and regulatory pressure for relaxed underwriting standards to expand home ownership created the preconditions for the bubble. Two government sponsored enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—securitized mortgages to add liquidity to housing markets. Financial

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institutions, freed from regulatory constraints, invested heavily in these securities, often hedging the risk with credit-default swaps. Through the process of securitization and the issuance of swaps, a largely unregulated system emerged that was tightly coupled, vulnerable to systemic risk, and because of its integration into the regulated financial institutions, capable of doing extraordinary damage (see Gelinas 2009).

Real estate markets began weakening in the second quarter of 2006, and as prices declined mortgage defaults increased dramatically. By 2007, the effects spread into a financial system with large investments in mortgage-backed securities, exacerbating what would become the deepest recession since the Great Depression. The collapse forced the failure or near failure of major investment houses and commercial banks, some of which were only saved via large infusions of public funds. The federal government was forced to adopt extraordinary measures to save the GSEs that had securitized mortgages and theAmerican Insurance Group, a major issuer of credit-default swaps. By the end of 2009, the combined costs of the bailout and stimulus package required the largest one-year issuance of debt relative to GDP since World War II (See Congleton 2009). Thus, a period that began with an ode to the marvels of the market ended with unprecedented foreclosures and bailouts, somber discussions of bank nationalization, and a search for a new regulatory architecture for finance.

Finance offers a host of lessons, many of which are beyond the scope of this paper. It clearly illustrates both the way in which public policy and institutions constituted distinct financial industries and the unanticipated effects of deregulation on governance. The shadow banking system that emerged in the gaps created by deregulation was in many ways unanticipated and thus, was largely beyond the reach of existing regulatory institutions. More importantly, it shows that economic performance in a deregulated environment is not easily captured by the logic of the market. As the post-2007 crisis reveals, performance and stability are not simply matters of regulation, even if regulation (or the lack of effective regulation) plays a significant role. In this case, changes in the tax treatment of real estate, low-interest rates promoted by the Fed, and the social policy goal of expanding home ownership created the preconditions for an asset bubble whereas the process of deregulation

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eliminated the regulatory firewalls that might have proven instrumental in limiting the magnitude of the crisis (see Eisner 2011, pp. 180-198).

Regulatory Reform from an Institutional Perspective

This paper began with some reflections on the inadequacy of the market-state dichotomy that has been used to frame public discourse about deregulation and regulatory reform more generally. It was argued that law plays a central role in constituting the economy, facilitating the activities of economic actors, and shaping decisions about governance. In this final section, we must turn to a simple question: what is gained by adopting an institutional perspective?

The first response is an empirical one. Classical markets certainly exist and are employed on a regular basis. But as the above cases suggest, one cannot explain the governance in deregulated industries if one works within the broad terms of "the market" versus the state. The dense organizational networks created in the airlines and the long-term bilateral contracts and intermodal alliances in surface transportation are neither self-liquidating nor anonymous; they cannot be described accurately as markets. Moreover, the control over key assets exerted by legacy airlines and consolidated Class 1 railroads have important implications for the relative power of actors within the respective industries. The category of "the market" is simply too broad and imprecise to capture the wide variety of mechanisms that economic actors use to coordinate their behavior and this limitation can be addressed by adopting a governance perspective.

The second response involves the implications for public policy. As noted above, policy analysts who work with the broad categories of the market and the state routinely ask when it is justified for the state to "intervene" in the market. The positive theory of market failure has provided the central analytical framework for making these determinations. An institutional perspective takes us beyond such simple questions. The law provides the very foundations for economic activity through its definition of property rights and its role in constituting key economic

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actors and delimiting the possible relationships among them. To simplify things a bit, there are no markets (in the broadest sense) without the law, and there is no law without the state. Thus, to employ the positive theory of market failure to determine when the government is justified in "intervening" in the economy is, at best, misleading. It would be more accurate to recognize the variety of ways in which public policy shapes the behavior of economic actors, even under conditions of deregulation. As shown above, the financial collapse of 2008 was a product of public policy decisions regarding taxation, interest rates, and access to credit. In sum, law and public policy are as foundational in a deregulated setting as they were under regulation, even if the effects are different.

The third and final response brings us to normative concerns. If we view the market (once again, in its broad sense) as being self-constituting and self-regulating and if we assume that policymakers must have a clear justification (market failure) to intervene, we are simultaneously assuming that market outcomes should be accepted as given. The distributions of wealth, power, and opportunities in society can be cast simply as the emergent properties of voluntary interactions within the market. If one frames deregulation, in turn, as a transfer of control from the state to the market, one may conclude that citizens can no longer harbor expectations of public accountability for the results. Yet, if regulation *and* the collection of governance mechanisms that are employed in a deregulated environment are expressions of public policies and public institutions, it is legitimate to demand that elected officials assume responsibility for ensuring that economic actors remain accountable to broader social values. These expectations, which were at the core of the regulatory initiatives of the past century, are not vanquished as a result of regulatory reform.

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